



August 12, 2011 – Commentary

“Well, Here’s Another Fine Mess You’ve Gotten Me Into.”
- Oliver Hardy to his friend Stan Laurel

It is not our intent to make light of the situation in the global economy or the recent volatility in stock market indexes and individual portfolios. However this line kept coming to mind as we watched events of the last few months / weeks unfold.

In the last 2 weeks we have read countless commentaries provided to us by our portfolio managers. We have read and watched interviews with leading economists, academics, business executives and investment managers. We have also taken part in conference calls with no fewer than 22 portfolio managers. Our job is to take in all of this information, digest and analyze it and then build financial plans and investment portfolios that are suited to your personal circumstances.

This commentary is not to be construed as an investment recommendation to anyone. Rather, it is a general commentary and not a solicitation to buy or sell investment funds. We have purposely not directly quoted any particular managers or mentioned any of the mutual funds which are available to you.

We will, right up front, admit but not apologize for the length of this commentary. The question of your portfolio and financial security is an important one and we want to give a full and thorough commentary – rather than platitudes and buzz lines.

What Happened? Where are we? What’s next?

After the financial crisis of 2008/09, the major market indexes in North America bottomed out in March 2009. Both 2009 and 2010 were generally very positive years for stocks, even though there were days, weeks and months when they were either flat or down significantly. The first quarter of 2011 was generally positive. However stocks began a gradual decline in early April and this trend continued into May, June and July.

Corrections are a common attribute of equity markets. Since the highs of April until the end of July, the markets were down by what might be classified as normal levels. In fact until the waterfall declines that began in the first week of August, this summer’s decline was very similar to the summer of 2010. That slow / negative summer had investors nervous and it set the stage for the great increases that were experienced in Q4 2010 and Q1 2011. Markets often see major price swings in the summer because the dog-days of summer often have fairly thin trading volumes and price changes are magnified because of the low volumes.

Since the rise of the Tea Party in the summer of 2010 and the recent election of intransigent freshman congressmen and women there has been much noise about the US budgetary deficit and the raising of the debt ceiling. The inexperience and ignorance of these newbies as well as the ineptness of the congressional leaders and the President brought the USA to the brink of an unprecedented default on their borrowings. As you well know, a deal was cut and the debt ceiling was raised. So all should be good - right? Not so fast.

There is no doubt that the budgetary deficit of the US government is a serious matter. The deal that was cut, although more than a band aid, is no where near the major surgery that is required of the U.S. government's tax and spending policies in order to balance the budget. Having said that, we believe the recent decision by Standard & Poor's to downgrade its credit rating on U.S. government debt is unwarranted. You will recall that it was S&P and the other rating agencies that were giving glowing ratings to mortgage backed securities that ultimately were deemed toxic and which led to the financial crisis of 2008/09. We believe that they are now over reacting so that they do not get criticized down the road. S&P themselves said that a default by the US government is not imminent, but rather they are looking down the road, and in their view the politicians have demonstrated that they do not have what it takes to come to a deal on the tax increases and spending cuts that are needed for long term financial health of the country. The S&P decision to cut its rating on US government debt really was a political statement and it will be debated for some time as to whether it was warranted or appropriate.

Remember that the other two major rating agencies have left their AAA rating of US government debt in place. If nothing else, hopefully this is a wake up call to politicians of all stripes that fiscal issues need to be dealt with. It should also be stated that politicians of all stripes (around the globe) need to wake up and realize that the number one issue is jobs and a close second is the education and training of a skilled workforce. If people are gainfully employed and paying taxes then they are drawing less from government revenues, they do not have time to dress up like they are going to go throw tea off of ships in Boston harbor and they don't have time to go protest at government offices or riot in the streets.



There is no doubt, given the speed of the drop that fear became the main driver of this recent sell-off. Concerns about the U.S. fiscal situation, massive government debts in Europe, fears that the U.S. and other developed economies could be going into recession again have led to certain market participants driving down stock prices on companies all over the world. Conversely, gold has been driven to an all time high price (although on an inflation adjusted basis it is still below its peak). All of these issues, as usual, have been poorly explained, highly overblown and massively distorted by the mainstream media. U.S. government debt is as credit-worthy now as it was before the downgrade – the only fact that has changed is that a rating agency has pointed out what everybody knew - U.S. public debt is high and there is no clear course laid out that will reduce its

growth. That is not news. The creation of multiple 24 hour news channels, some of which are dedicated to covering business, stock market activity and the investment world



has given rise to what we call infotainment. For some reason, North Americans love to sit in their homes and watch people talking on their TVs. Personally, we'd rather spend time with family, friends, watching a good movie or sitcom or reading a good book than listen to the bickering and prognostications that are incessantly projected on the innocent and unsuspecting public.

Generally speaking we can explain some of the action taken by market participants, but other actions have us, and others, scratching our heads. We understand that some have allocated a larger portion of their portfolio to gold bullion and this strong demand has driven prices higher. For some time we have, where appropriate been recommending this to our clients. We don't understand why market participants have been selling shares of good, strong, iconic companies and despite the credit rating downgrade, have been buying U.S. Treasuries. This is counterintuitive if the reason for the stock sell off is the instability of the U.S. We also are somewhat perplexed as to why the U.S. dollar has been rising against the \$CDN when our fiscal situation is much stronger than theirs. Yes, it can be explained that we are a resource based economy and with lowered economic growth and lower demand for our commodities there will be less money flowing into the country. However, we believe this view is very short sighted, and will explain why later in this bulletin. Thus far this year, the prices of gold mining companies have not risen along with the price of bullion. We believe that with higher bullion prices will come higher earnings and those that own shares of producers will be rewarded.

Although the recent decline is reminiscent of the financial crisis of 2008, today's conditions, particularly in North America, are vastly better than three years ago. You will recall that in 2008, a number of financial institutions collapsed and the credit markets froze entirely, which contributed significantly to a recession, as many companies were unable to borrow to invest or conduct business.

Today, in contrast, credit is available and corporations are flush with cash. Many banks and other companies have taken the last three years to strengthen their balance sheets. Tellingly, corporate bonds have held their value well in comparison to share prices. In fact, corporate revenues and profits continue to grow. For the second quarter, 77% of the companies listed in the S&P 500 Index have reported earnings that were higher than expected, and their sales grew by an average of 12.5% over a year ago.

Are there stresses that could turn the economy negative for a while? Sure there are. There are also many positives to keep in mind. Interest rates remain low and the U.S. Federal Reserve recently confirmed that they will keep rates unusually low for the next 2 years. In addition, energy prices are nowhere near the levels of 3 years ago. Both of these factors will support business and consumer spending. Employment levels continue to grow in Canada and the United States. Though the pace of economic expansion in developed countries is slowing, forecasters are still calling for positive growth this year. Strong growth is expected to continue in Asia (especially China and India) and throughout Latin America (especially Brazil).

On this point we have to be blunt – Americans have to realize that they are not the king pins that they once were. As Canadians we are bombarded with news about the U.S. and we relate to it because of our proximity. The real economic powerhouses for the coming decades are China and India. It is time for North Americans to get over it and start dealing with reality. World growth, a massive move of people from an agrarian society to urban, middle class lifestyles and industrialization of the Asian landscape will be supportive of strong energy and natural resource prices.

What does this mean for us as investors? It is very difficult to sit through a downturn, especially with the financial crisis of 2008/09 still fresh in our minds. However, as we have said before, volatility is a normal part of investing. Historically, equity markets have eventually recovered and benefited investors who stayed the course. We saw this again three years ago, when the financial crisis was followed by a powerful rally in stocks in 2009.

Taking the Long View

There is a marked difference between financial planning and investment management.

For people who are still working, the financial planning process takes into account your income and expenses, and allocates excess funds toward short term objectives and long term objectives. Retirees on the other hand need to look at their fixed and variable expenses and then assess their income sources from government and employer pensions as well as investment income from their portfolios and, where necessary, drawing down on capital. Financial Planning is also a process of assessing the risks that can thwart your plan and putting in place insurance and legal documents to deal with those contingencies. The plan should take into account both inflation and taxes and creatively structure assets in an efficient and effective manner. No two individuals will have the same financial plan - that is why we call it Personal Financial Planning. Of course there will be common principals applied – particularly as it applies to tax planning and general investment philosophy.

Investment management on the other hand is the process of effectively managing a portfolio of assets within certain parameters as determined by an investment mandate. A manager with a mandate to invest in government bonds will not consider investing in gold bullion and a manager with a mandate to invest in companies throughout Asia will not consider investing in government bonds. We look for managers that stick to their knitting and invest the money entrusted to them in a consistent fashion. We also look for managers that can identify trends, invest in companies that will benefit from these trends and opportunistically take advantage of day to day moves.

The marriage of financial planning and investment management is where a portfolio is built. If a young couple is saving for a house, this money should not be exposed to potential downturns in the stock market. On the other hand, retirement assets which are being saved and invested to accumulate capital and eventually produce retirement income can not be left to sit idle in bank accounts and term deposits. This money earmarked for retirement needs to be invested in equity investments like real estate, commodities and

businesses that will increase in value over time. There are two basic ways you can invest in commodities, real estate (whether vacant land or developed) and businesses.

You can invest in a private business (either one you start or an existing business where the owner is looking to sell all or a portion of the company) or you can invest in a publicly traded business (where shares are traded on a stock exchange). You can invest in a piece of real estate by yourself, with some associates or with a wide group of investors. You can invest in commodities by actually acquiring them (gold bars, barrels of oil, etc) but of course you would have to deal with such issues as storage, security, environmental permits, etc.

No one will get wealthy or even financially secure by simply lending their money to credit unions, banks and governments. Wealthy people own assets that grow in value, provide inflation protection and produce income or capital gains.

The stock exchange is simply a mechanism to allow businesses to raise capital through share offerings and then bring together buyers and sellers of businesses. The regular, efficient exchange of business shares is what is occurring on a minute by minute basis. Some of those sellers are strategically shifting their allocation or turning assets into cash (to spend) and others are simply panicked and selling assets without any regard to price and value. The key thing to remember is that every time someone sells a share, someone else is buying it. The question to ask is do you want to be the person buying or selling at low prices relative to true value.

We don't know any business / commodity / real estate owners who sit down at the end of each day and tally up the value of their private investments. Rather they focus on building a strong business which provides products and services desired by their customers. By doing this day in and day out they build loyal clients which lead to profits, which in turn lead to increased business value.

In terms of a private business you might think of the guy who started in his basement, eventually rented some space, eventually bought his own building and eventually sold his business and retired happily ever after. The same thing happens with publicly traded businesses. A person invests a little each month, their shareholdings grow, they reinvest the dividends they are paid (yes the value of the shares fluctuates everyday) and eventually they retire and draw out a little each month to produce the cash flow they need to enjoy a happy retirement.

In terms of publicly traded business, think of "Sam" a 30 year old investing in the S&P 500 (a broad reflection of the performance of U.S. stocks) to save for retirement. The S&P 500 was at 22.79 on Aug 10, 1951. Sam invests each month, each year through good times and bad. Through Republican and Democratic Presidencies. Through wars, assassinations (Kennedy, Kennedy and King come to mind). Through periods of success and excitement like the achievement of landing on the moon and the invention of the computer. Through periods of uncertainty, like the Cuban missile crisis, oil shortages and the cold war. Through government deficits and surpluses, political squabbles, near presidential impeachment, tax cuts and tax hikes. Well, thirty years later on August 10, 1981, when our Sam is 60, the S&P 500 was at 133.85. This is an increase of roughly six

fold even though there were years where it was flat or negative. If Sam retired at that time and started to rely on his investments to produce retirement income each month and each year, he again went through good times and bad. Through Republican and Democratic Presidencies. Through wars and assassination attempts. Through periods of success and the achievement of the space shuttle program and the invention of the microprocessor and all the computer and electronics that followed. Through periods of uncertainty like Y2K and 9-11 to the rejoicing with the fall of the Berlin Wall and the Soviet Union. Through government deficits and surpluses, political squabbles, near presidential impeachment, tax cuts and tax hikes. Through Reagan locking out the air traffic controllers, hyperinflation and soaring interest rates, to house prices falling off of a cliff, interest rates near zero and the rise of the Tea Party. Well, thirty years later on August 10, 2011 when our Sam is 90 the S&P 500 was at 1120.76 (an increase of more than 8 fold). Something tells me that Sam is better off having invested in a broad section of American enterprise than he would have been if he left his money under a mattress, in a bank account or having bought term deposits and government bonds.

(Note: The S&P 500 closed at 1,172.64 on August 11th, more than 4.5% higher than the day before and almost exactly at the same level of August 9th which was 1,172.53.)

A Canadian Icon

Let's look at an example that we can all relate to (because it seems you can't drive a mile without passing one of their stores) – Tim Horton's (Tim's). On April 3, 2006 you could buy a share of Tim's for \$26.20. On November 5, 2007 that same share had been bid up by over 50% to \$39.73. On November 17, 2008 (during what we now call the financial crisis of 2008/09) that share of Tim's traded for \$20.57 – more than 20% below its value 2.5 years earlier and roughly 50% below its peak value roughly 1 year earlier. Did the value of the business really change that much over this time or was this just the euphoric and panic selling of shares without regard to the true earning potential and value of the business. Well, shares of Tim's went up and down on a daily basis since then and on May 9, 2011 a share of Tim's was valued at \$50.42. That's roughly 2.5 times the value just 2.5 years earlier. Finally, on August 8, 2011 shares of Tim's traded at \$42.46 down more than 15% since May 9th.



Ask yourself the following questions:

- 1) Is Tim's profitable?
- 2) Will Tim's be in business 5 and 10 years from now?
- 3) If money was no object and you could afford it would you buy the entire business and use the monthly profits to support your retirement?
- 4) If you owned all of Tim's in April 2006, would you have sold it all in November 2007 (at a 50% profit) with the plan/ idea / hope that you could buy it back 1 year later for half of what you just sold it for?
- 5) Similarly, would you have sold the entire company on May 9th thinking you could buy it back at a 15% discount 3 months later?

Similarly, you could ask yourself those 3 questions about Royal Bank, Great West Life, BCE, Trans Canada Pipelines, Toyota, Microsoft, CN Rail and Exxon to name just a few companies from different sectors. The portfolio managers that we recommend to you are charged with building portfolios of great businesses that have increasing profits and whose enterprise value will increase over time.

Summary

With interest rates being so low, and with the potential for rising inflation, investors need to hold part of their portfolios in assets such as high-yield corporate bonds and stocks in order to achieve their financial objectives. That's why we believe that a diversified portfolio, tailored to your individual goals, is the best approach to investing.

No one can say for certain when this latest period of pessimism and worry will end. However, history shows that markets eventually recover and that long-term investors (ie business owners) are rewarded.

We are here to serve you in what ever way is needed and we are dedicated to helping you reach all of your financial goals.

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